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No. ~~846~~. 67

IN THE

Supreme Court of the United States,

OCTOBER TERM, 1928.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

AMERICAN CODE COMPANY, INCORPORATED.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

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BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

Statement.

The facts are fully stated in the opinion of the Court below (Record, p. 15) and in the petition for certiorari.

Question Presented.

Are damages for a breach of contract incurred and sustained on the date of the Breach, entitling a taxpayer, making income tax returns on the accrual basis, to take deduction therefor from income of the year in which the Breach occurred?

Statutes Involved.

This case involves the general law of contracts and Revenue Act of 1918, C. 18, 40 Stat. 1057, Secs. 234, 212 and 232. Sec. 234(a) of said Revenue Act permits the deduction from gross income of:—

> "(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *
>
> "(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise; * * *

Sec. 234(a), Sec. 212 (permitting the filing of returns on the accrual basis) and Sec. 232, are fully set forth in petitioner's brief and are not here again repeated.

Argument.

It should first be pointed out that the Revenue Act of 1918 Sec. 234(a) contains no provisions defining when an expenses or a loss is "incurred" or "sustained", so that necessarily the Courts must look to General Rules or other specific Statutes applicable to the different branches of law when such a definition is a prerequisite to a decision. In this case the Court below has given effect to a cardinal principle of the law of contracts as established by decisions, not only of the highest Courts in State Jurisdictions, but also by decisions of this Court, that damages for breach of contract *are suffered when the contract is broken* and *are assessed as of that date. Parker* v. *Russel*, 133 Mass. 74, 75; *Pierce* v. *Tenn. Coal Co.* 173 U. S. 1. That this is true is admitted by the petitioner in his brief (p. 13), but he contends that, nevertheless, the decision in this case is in conflict with decisions of the United States Court of Claims and of this Court, because, although incurred or sustained in the year of the breach, the amount of the expense or loss was not in that

year fixed at a definite sum. Such argument in behalf of petitioner is not tenable under the Revenue Act, in the light of previous departmental interpretation, or under the decisions themselves, as we will point out.

The sections of the Revenue Act of 1918 here involved, do not require that an expense or a loss incurred or sustained in any year be converted into a definite fixed amount in that year as a condition precedent to an allowable deduction, nor have such sections been so interpreted by the Courts or by the Commissioner of Internal Revenue himself. In the case of *United States* v. *Anderson,* 269 U. S. 422 (a case relied on by petitioner in his brief), this Court, referring to Treasury Decision 2433 (under the 1916 Act), which allowed a taxpayer to set up and deduct reserves to meet liabilities the "amount of which or date of maturity" was not definitely determinable, and which provided the method of readjusting such reserves when the actual amount of the liability was definitely ascertained, said (p. 438):

> "We think the Statute was correctly interpreted by the Commissioner and that his decision referred to was consistent with its purpose and intent."

The case now sought to be brought before this Court for review is not only not in conflict with this Court's decision in *United States* v. *Anderson,* but is actually in accord with and carries out the principles established therein, as the Court below pointed out in its opinion (Record, pp. 17 and 18).

The decision of the United Stats Court of Claims in *Malleable Iron Range Co.* v. *United States,* 62C, Cls. 425 and 65C, Cls. 441, with which the decision in this case is claimed to conflict, involved neither facts nor law similar to or applicable to our case. In the former case, the claimed deduction was based upon a judgment awarded for patent infringement occurring over a continuing period of six years (1905-1911). In the present case the deduction is based upon a breach of contract which occurred on a date in May, 1919. In the former case the taxpayer was not seeking to make the deduction in the year or years of the infringement, so that the

court was not called upon to apply any rules of Patent Law to determine when damages for patent infringement are "incurred" or "sustained". In our case the taxpayer did seek to make the deduction in the year in which the breach occurred, and the Court below, looking to the law of contracts for a definition of the time when damages for a breach are "incurred", found a well established principle that such damages are *"sustained when the contract is broken and are assessed as of that date"*, and applied such principle to the provisions of Sec. 234 (a) Revenue Act of 1918, in accordance with the contemplation of the whole Taxing Statute and the decision of this Court that the changes in the Taxing Statute made in 1916 were—

> "to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period;" *United States* v. *Anderson*, 269 U. S. 422 at page 440.

The Court of Claims in its first decision, had before it incomplete findings of fact, and such expressions as "when the amount in question is in litigation it cannot be determined until the litigation is ended", contained in such decision (62C Cls. 425 at p. 432), are clearly dictum in the light of the opinion rendered after the case was remanded to it by this Court for additional findings, when it was disclosed that no such question was presented. The actual decision rendered in the case (65C Cls. 441) held that a taxpayer who had accrued on its books an amount equal to the security given to cover a judgment awarded for patent infringement, was entitled to deduct such accrual *without waiting for final determination either as to the vadility or amount of the judgment* by higher courts to which appeal had been taken. Only in this latter respect are the two cases at all similar or parallel and in this respect *they are in complete accord.* This decision of the Court of Claims is also in accord with a previous decision of the Court below in

Becker Bros. v. *United States,* 7 F (2d) 3, referred to in petitioner's brief.

Counsel, in their supporting brief, refer to two further cases, a District Court decision, *Consolidated Tea Co.* v. *Bowers,* 19 F (2d) 382, and the decision of this Court in *Lewellyn* v. *Electric Reduction Co.,* 275 U. S. 243, the latter being a case chiefly relied on by the petitioner in the Court below, and discussed in the opinion below (record page 18). In the *Consolidated Tea Co.* case the deduction was based on a claim for commissions earned, reduced to judgment, and sought to be deducted, not in the year or years when the commissions were earned, but in the year when the judgment was rendered. The Court said, in its opinion, page 384:

> "It seems to me that the time of the mere rendering of a judgment is not the controlling factor in determining when a loss is sustained * * *. From a tax income standpoint, both logical and practical reasons seem to me to support the conclusion that a loss should be deductible not in the year when the judgment was rendered, but in the year when the claim was adjudicated to be final and definite, or possibly under certain circumstances in the year when the claim originated."

The case of *Lewellyn* v. *Electric Reduction Co., supra,* involved the deduction of a debt ascertained to be worthless and not damages for breach of contract, so that the decision was controlled by entirely different provisions of the Revenue Act, and has no application direct or implied to the question presented in this case. In the *Electric Reduction Co.* case, this Court held that on the facts the taxpayer had elected to treat his claim as a debt and that, therefore, it was deductible in 1922 under sub-section 5 of Sec. 234, Revenue Act of 1918, C. 18, 40 Stat. 1057, as a debt ascertained to be worthless in that year, and not in 1918 under sub-section 4 as a loss deductible when "sustained". The taxpayer had not elected to treat the purchase and sale contract under which it made prepayment, as abandoned by the seller in 1918, and had not made an accrual on its books of a 1918 loss, but had carried the prepaid amount on its books as one of its "bills

receivable" until the judgment which it ultimately recovered proved uncollectable.

The decision of the Court below does not overturn Article 111 of Regulations 45. It is strictly in accordance with its provisions that each year's return, so far as practicable, both as to income and deductions, should be complete; that the expenses, liabilities or deficit of one year cannot be used to reduce the income of a subsequent year, and that a person making returns on an accrual basis, has the right to deduct all authorized allowances, whether paid in cash or set up as a liability. It clarifies and ends the confusion which has existed over those provisions of Article 111 in which the Commissioner attempted to define, in certain specific cases, the time when a certain kind of loss or expense is incurred or sustained, a clarification, the necessity for which the Commissioner has already recognized by the change made when Article 112, Regulations 65 were promulgated.

Article 111, Reg. 45 provided:

> "* * * A person making returns on an accrual basis has the right to deduct all authorized allowances, whether paid in cash or set up as a liability, and it follows that if he does not within any year pay or accrue certain of his expenses, interest, taxes or other charges, and makes no deductions therefor, he can not deduct from the income of the next or any subsequent year any amounts then paid in liquidation of the previous year's liabilities. * * * Any amount paid pursuant to a judgment or otherwise on account of damages for personal injuries, patent infringement or otherwise, is deductible from gross income when the claim is put in judgment or paid, less any amount of such damages as may have been compensated for by insurance or otherwise. * * *".

Article 112, Reg. 65 and 69 provided:

> "* * * A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he can not deduct them from the income of the next nor any succeeding year. It is

recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. Judgments or other binding adjudication, such as decisions of referees and boards of review under workmen's compensation laws, on account of damages for patent infringement, personal injuries, or other cause, are deductible from gross income when the claim is so adjudicated or paid, unless taken under other methods of accounting which clearly reflect the correct deduction, less any amount of such damages as may have been compensated for by insurance or otherwise. * * *".

The decision in this case creates no confusion in the administration of the income tax law, but on the contrary it effectively ends the confusion which has heretofore existed in similar cases, caused by the conflicting decisions of the Board of Tax Appeals, acquiesced in by the Commissioner of Internal Revenue, in the cases of *Appeal of Producers Fuel Co.,* 1 B. T. A. 202, and *Hidalgo Steel Co.* v. *Commissioner,* 8. B. T. A. 76. The inconsistency of these cases is fully discussed and pointed out in the opinion of the Court below (Record, p. 17).

The decision herein establishes no new or hitherto unsupported rule of law. It is in conflict with no previous decisions of this Court or of lower Courts. It applies a well established rule of Contract Law to interpret the Revenue Act of 1918 in a way which is in full conformity with the provisions of that act and with other decisions of the Courts thereunder, particularly the decision of this Court in *United States* v. *Anderson, supra.* The petition for a writ of certiorari herein should, therefore, be denied.

Respectfully submitted,

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